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Realigning monetary and fiscal policies in India: an analysis of the debt sustainability of the general government due to monetary-fiscal policy interactions during Covid-19-lessons learnt and the post-pandemic path to-be

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Abstract

The last two and a half years have been very difficult for the world economy on account of the Covid-19 pandemic. Prolonged lockdowns, sudden supply-chain disruptions, slump in demand owing to reduced incomes, job losses and perceptions of insecurity and uncertainty among the consumers, and huge expenditure by governments the world over has put tremendous strain on the macro-fiscal health of all the economies. India also faced similar challenges in ensuring that the nation waded through the pandemic with minimal loss, if not none. The very immediate response of the Government of India was to take various measures to provide safety-nets for the vulnerable sections of the society/ small business and self-owned small enterprises, followed by comprehensive as well as sector-specific stimulus packages since the second half of 2020-21. The RBI also deployed a range of instruments to ensure adequacy of liquidity, financial stability and promote growth (Ministry of Finance, 2020). These fiscal and monetary measures affected the future inflation and growth trajectory in mixed ways with much of positives and some negatives. A year to the pandemic, just when the world was preparing to come out of the shock, a full-scale conflict erupted between Russia and Ukraine which badly hurt the recovery process with deep supply chain disruptions, soaring crude oil prices and decisions taken under geopolitical misadventures that derailed the private investment. In the context of India, despite being comparatively well placed vis-à-vis other countries, we are presently seeing high inflation coupled with stagnating demand induced by lower income levels, dented and skewed consumption preferences, supply side shocks and low private investment and a depreciating Indian Rupee vis-à-vis the US Dollar. As the effects of the pandemic fade, the policy makers and researchers are occupied in developing economic approaches that ensure a sustained future growth path. However, the pandemic has certainly brought to the fore a stark realization that a fine balance between fiscal and monetary policies is a must to achieve a stable state of increasing growth and low inflation. It has also forced governments to rethink the concept of debt sustainability.

Keywords: monetary policy, fiscal policy, public debt, inflation, debt sustainability

Introduction

The Covid-19 pandemic and the consequential lockdown measures adversely affected economic health of India, with the April-June 2020 quarter registering a massive contraction of 23.9% in real GDP (as per a contributed paper by the RBI in (BIS, 2022)). Though the main anchor of economic revival in India has been increased private sector investment post-COVID, an innovative rethink on monetary-fiscal policy mix is needed for ensuring sustained growth process in the years to come. While there are both pros and cons of standalone fiscal stimulus vis-à-vis fiscal consolidation policies in normal times, extraordinary times like those of pandemic years require focusing more on how these policies can work with effectiveness taking in tandem the inflation levels, the debt to GDP ratio and the growth (GDP growth rate) – unemployment relationship. Also, General government debt beyond sustainable levels can thwart all good fiscal policy efforts thereby rendering ineffective the monetary policy stabilization as well.

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As a proxy to the health of financial sector in Indian economy, an analysis of Sensex and Nifty-50 levels since FY 2021-22 reveal that the rebound of consumer confidence, as reflected in increase in retail investors (proxied by increase in new demat accounts), and private sector investments, as reflected in share prices and market capitalization of large cap companies, were very sharp in the first half of FY 2021-22. However, these positive sentiments have since waned and the market is going nowhere on a close-to-close basis since the second half of FY 2021-22. FII outflows have increased drastically given the strengthening of US Dollar vis-à-vis the Indian Rupee. Inflation is reigning high. Global headwinds are indicating the start of a prolonged and damaging global recession with the spectre of defaults at some of the major global financial institutions such as Credit Suisse and Deutsche Bank.

India has had a complex history of coordination between monetary and fiscal policies which at times has proven to be an asset for Indian economy. Be it the macroeconomic crisis of 1990; Global Financial Crisis of 2008; or depreciation of Indian Rupee in 2012 and its consequential impacts, this coordinated policy stance of Government of India on both the fiscal and monetary fronts has proved to be beneficial for the economy. However, the Covid-19 pandemic has presented entirely new set of challenges in terms of its lingering economic impacts and permanently changed perceptions of citizens (consumers and producers) at large.

In the backdrop of new set of challenges brought out by the pandemic and the ongoing turmoil in global geopolitical and macro-economic front, the challenge before the Govt. of India is to find an appropriate, and yet novel, mix of monetary-fiscal policies for a sustainable and growth-bound post-pandemic future without crossing sustainable levels of public debt.

Objectives

This paper aims to examine the following:

1. Monetary and fiscal policy responses to the pandemic in India.
2. How policy interactions during the crisis time impacted the debt sustainability of the government.
3. The right kind of fiscal-monetary policy mix and timely rebalancing thereof needed for the Indian economy to achieve a steady state of growth and sustainable economic development so as to serve as an effective learning from the pandemic struck past as well as to serve as a potent driver of growth in future.

Methodology

This paper is an analytical and doctrinal study based on secondary sovereign data sources of macro-fiscal and monetary indicators. It attempts to examine the existing academic and empirical findings regarding various interrelationships between public debt, GDP (as a proxy to the growth rate), inflation and interest rates while attempting to suggestively comprehend the possible appropriate mix of monetary and fiscal policies in the post pandemic scenario for the Indian economy. The secondary data sources used in this paper are, chiefly: publications and working papers of the RBI, status papers of the Department of Economic Affairs, Ministry of Finance on public debt and fiscal policy, Economic Surveys for the year 2020-21 and 2021-22, OECD and UNCTAD reports on impact of Covid-19 on various sectors of world economy, IMF, BIS and European Parliament's research documents on interaction between monetary and fiscal policies in the wake of the pandemic.

Policy response to the pandemic in India:

Monetary Policy

The immediate task before RBI right from February, 2020 was to ensure financial stability by managing high volatility in financial markets and large-scale capital outflows due to extreme risk aversion, and to ensure adequate liquidity, chiefly for the banking and private sector. The stabilization measures of RBI included long-term repo operations, open market operations (OMOs) to buy Government of India securities thereby reducing government's borrowing costs, countercyclical measure of continuous rate reductions by the MPC, a one-time reduction in the cash reserve ratio of banks, forex purchases and widening of the monetary policy corridor (the area between repo rate and MSF rate). Despite the inflation rate crossing the upper tolerance level of 6% in June-November 2020, the RBI chose to retain its accommodative stance for the FYs 2020-21 and 2021-22. The RBI also indirectly accommodated fiscal deficit of the government through OMOs, increase in limits for temporary Ways and Means Advances (WMAs) (available for up to three months) both for the central and the state governments, additional G-Sec Acquisition Program (G-SAP) in H1:2021-22. To enhance liquidity in the system in a sector specific manner and to boost export credit at the time of trade contraction, additional facilities for uptake of funds were setup for the NABARD, SIDBI and the EXIM Bank. The RBI also supported vulnerable small enterprises by allowing the lending institutions to restructure their debt, subject to new reclassification of borrowers' accounts. While taking all these measures, RBI did not dilute the quality of its balance sheet by during asset purchase by solely focussing on purchasing government securities.

Fiscal Policy

The Government of India followed a measured and calibrated approach in undertaking fiscal interventions, with the immediate step being cash transfers to poor and vulnerable households and in-kind support through free foodgrains distribution (later extended as PM Garib Kalyan Yojana). Further supportive steps include increased outlay on expansion of healthcare infrastructure in the country by fast setting up of permanent/ ad-hoc health facilities, oxygen plants, medical insurance of healthcare workers, patient transport systems and setting up of the PM-CARES fund. The supportive measures were followed by stimulus packages to boost the economy such as the comprehensive Atmanirbhar Bharat Package (ANBP), Production Linked Incentives scheme, collateral free loans and credit guarantee scheme for the MSMEs, export boosting initiatives and sector specific interventions. While some of the measures caused additional expenditures, many were financed by reappropriation of funds from other heads of expenditure. The government also directed its spending more towards the priority sector areas during the pandemic. Reprioritization of expenditure was done towards more of capital expenditure than revenue expenditure, and from consumption towards investment. The size and composition of the stimulus, coupled with shift in focus from consumption to liquidity to investment, suggest that it is aimed at promoting recovery primarily through the investment revival channel. Alongside the aforesaid measures, the government embarked upon a nation-wide vaccination program to protect the whole nation from deadly effects of the virus and to contain the repeat waves of infection.

Monetary-Fiscal policy interactions during the crisis and debt sustainability

Fiscal multipliers are large and significantly greater than one during periods of economic slack/high uncertainty (Goemans, 2022)[1]; money-financed fiscal stimulus has larger multipliers than debt-financed stimulus (Gali, 2020)[2]. Based on analysis of estimation of asymmetric fiscal multipliers during periods of recession and expansion, the RBI has highlighted two broader inferences in this regard. First, that during a period of economic slowdown and low private demand, such as the post-pandemic situation, fiscal stimulus can help generate growth which can further increase through multipliers. Another empirical estimation of the fiscal multiplier effects of total expenditure on growth in GDP by the RBI

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shows that only capital expenditure was found to have an impact multiplier of greater than one (1.32) while it was found to be 0.79 for revenue expenditure and 0.72 for total expenditure, thus capital expenditure is particularly effective when economy is particularly in a slack phase Second, during economic expansion, negative multipliers are seen indicating that expansionary fiscal policy is harmful to growth.

1. As quoted in Chapter-II (Rebalancing Monetary and Fiscal Policies Post-Pandemic) of RBI's 'Report on Currency and Finance 2021-2022'.
2. Ibid

Fiscal consolidation, once the economy recovers, thus becomes an imperative for letting the private sector to sustain the growth momentum. On the contrary, monetary policy is effective in stabilizing output under both expansion and contraction. As stated by the RBI, "These findings corroborate the need for fiscal policy to take the lead in a post-crisis period to support growth, and timely fiscal consolidation to allow monetary policy to effectively stabilise the economy around the steady state during periods of expansion. Hence, as recovery gains further momentum, fiscal consolidation should ideally precede monetary policy normalisation to minimize trade-off costs."[3]

Now coming to the quintessential debt sustainability, it depends on the interest rate and growth rate differential – if the interest rate paid by the government is less than the growth rate, then the intertemporal budget constraint facing the government is no longer binding (Blanchard (2019)[4]. As per RBI, India's general government debt surged to 89.4 per cent of GDP in 2020-21, much higher than the FRBM target of 60 per cent, posing potential risk to macroeconomic stability in the medium term (figure 1). Debt levels can remain qualitatively sustainable only when Domar condition $(g > r)$[5] is always satisfied. Monetary policy can help debt management by keeping nominal interest rates (i.e., costs of borrowings) low for current and future debt, but that can be possible only in a low inflation scenario. If the real interest rate exceeds real GDP growth $(r-g > 0)$ then the debt to GDP ratio cannot improve, unless it is compensated by a primary surplus (surplus excluding interest payments). A high level of government debt can depress growth – an expansionary fiscal policy at high levels of debt can become effectively contractionary (Alcidi and Gros, 2019; Mohanty and Panda, 2020)[6] . As per RBI, general government debt up to 66 per cent of GDP, leads to increase in GDP growth beyond which it affects growth adversely at the rate of 0.01 per cent point reduction in GDP for each one per cent point increase in Debt-GDP ratio.

3. Ibid
4. Ibid
5. 'g' is the real GDP growth rate and 'r' is the real interest rate.
6. Ibid@1

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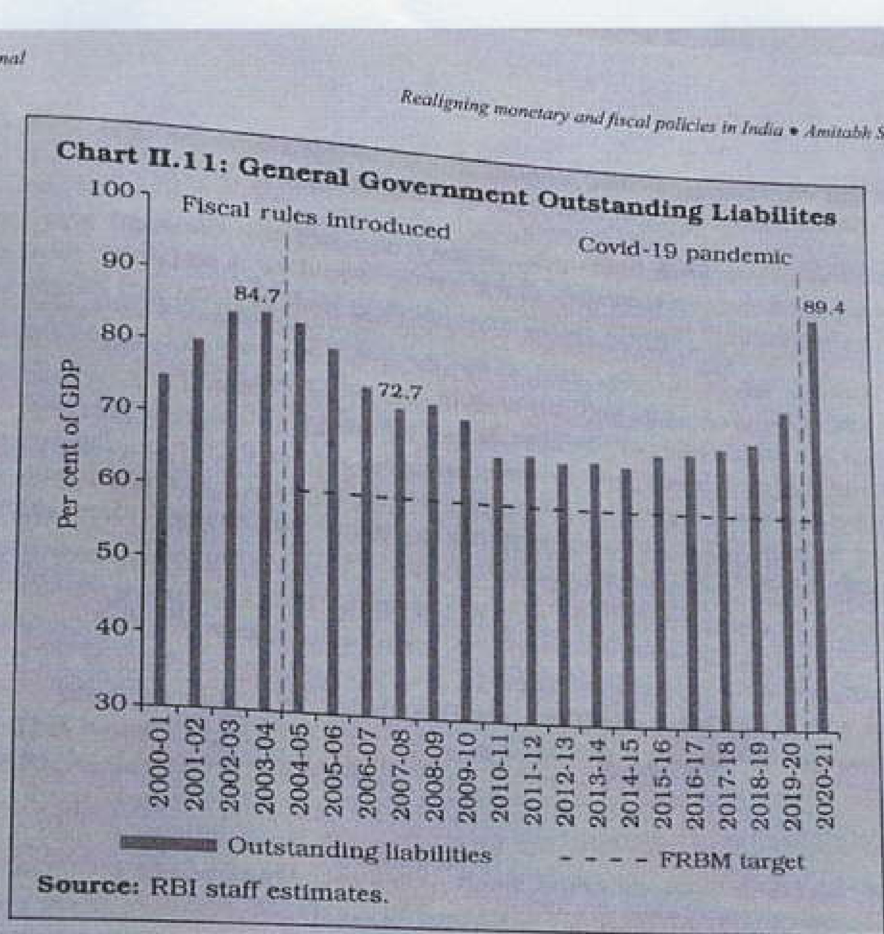

Figure-1: Source: Report on Currency and Finance 2021-22, RBI

The highlight of policy coordination in India has been that with all the actions RBI undertook alongside the fiscal policy, it has retained its independence on monetary front while not restricting the space for fiscal policy in any manner. Similarly, despite having risen significantly, the fiscal deficit will not politically hurt the RBI's independence as significant capital expenditure will ensure optimal growth rate and lower fiscal deficits in the long run.

Policy interventions and actions needed going forward: concluding remarks

These extraordinary post-pandemic times call for bold and innovative ways to boost the fiscal coffers, such as the recently launched National Monetization Pipeline (NMP) with total monetization plan of Rs.6 lakh crore, over a four-year period, 2021-22 to 2024-25, making it co-terminus with the balance period of the National Infrastructure Pipeline (2019- 20 to 2024-25). Asset monetization can potentially solve the twin problems of management of existing assets by tapping private sector efficiencies and financing of new infrastructure by unlocking the value of investment made in public assets which have not yielded appropriate or potential returns so far (Kant, 2021)[7]. It is hoped that the funds received by the government will be utilized in creation of new infrastructure with substantial multiplier effects on economic welfare. Further rationalization of expenditure and raising the country's tax to GDP ratio (and also the tax buoyancy) will have to be critical part of the monetary-fiscal realignment post-pandemic.

"In some EMEs, large fiscal deficits, should they persist, could undermine price and financial stability. Much higher levels of public sector debt, coupled with political economy constraints, may complicate the conduct of monetary policy and the interaction between the two policies will be challenging, especially given the need to eventually raise interest rates and exit from balance sheet policies. A large fiscal stimulus in emerging market economies (EMEs) post-COVID could raise the future inflation trajectory. Higher interest rates to deal with such inflation could endanger debt sustainability in a weak growth environment (as per a contributed paper by the RBI in (BIS, 2022)).

On the issue of deviation from fiscal rules, it may be noted that the ideal prescription in times of recession caused by a once-in-a-century global crisis, would be a sustained, productive program of permanent stimulus directed towards public investment in both physical and human capital (Krugman (2020))[8].

The now-started fiscal-monetary policy exit from the crisis-time accommodative policy mode should be done in a careful and steady manner, without disrupting economic recovery process. This can go a long way in improving macroeconomic and financial stability. As per RBI, '...a clear strategy of exit from the fiscal stimulus assumes importance. An orderly unwinding of RBIs countercyclical measures is also warranted along with the financial sector returning to normal functioning without relying on continuing regulatory relaxations as the new norm...'.

7. Ibid
8. Ibid

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